

US Rates Strategy Weekly

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- **We expect the Fed to raise rates at next week's FOMC meeting.** There is some uncertainty about what the FOMC needs to see to be convinced inflation is cooling. **The Fed may need to hike in September to counter doubts that its commitment to price stability is only verbal.**
- **Term yields have been in a "disappointment" feedback loop since July.** The market was disappointed the Fed did not raise rates that month and the subsequent backup in term rates prompted the Treasury to unexpectedly increase its buybacks.
- But markets were again disappointed by the announced size of this week's buyback and again when the Treasury bought back less than its \$6bn offer maximum.
- Overall, our sense is that any effect from heavier corporate issuance on 10y yields is small; half of the back up in yields since the July FOMC meeting reflects inflation expectations and a series of policy disappointments.
- **Ten-year yields near 5% appear compelling.** We think the medium-term risk-reward favors adding duration as markets fully price in supply, oil and credibility concerns.

Serial disappointment

We look for the Fed to raise interest rates next week, pushing the new fed funds target band up 25bp to 3.75-4.00%. Since the Chair's Jackson Hole appearance, the data flow has remained firm; indeed, payroll data point to a now-firmer labor market. And while the inflation readings were friendlier this summer, they don't appear to have established enough of a *trend* to convince the Chair that price stability is returning. However, in his [key principles](#) outlined at Jackson Hole, Warsh provided no guidance about what might sufficient. As a result, markets are uncertain about how much weight to give to the August CPI report. Our sense is that the Chair has a somewhat broader definition of trend. He appears to be looking at the relative distribution of prices within the monthly inflation reports and evidence that they are slowing quickly.

We expect the FOMC statement to look almost identical to the July one – repeating both the "elevated" inflation language and the Committee's commitment to "deliver price stability". The number of FOMC members looking for at least one rate hike this year may have increased by 2 or more in September. Several FOMC members including Chair Warsh appear open to reducing the number of annual FOMC meetings from 8 to 6.¹ Reducing meeting frequency might give the Fed more time to analyze incoming data. Any discussion might show up in the Minutes on October 7.

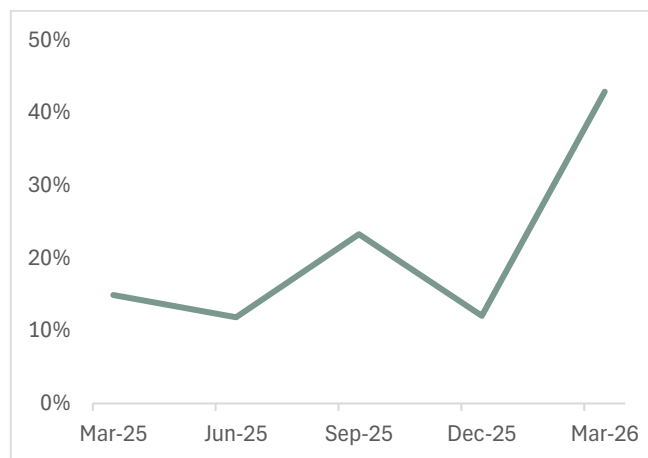
¹ See, "Fed Officials Signal Openness to Holding Fewer Policy Meetings", A. Ackerman and C. Saraiva, Bloomberg News, September 9, 2026

For a Fed Chair looking to markets for guidance, equity and bond prices point to solid growth and robust spending. S&P500 profits are up 20% y/y and forward earnings and capital expenditure plans are robust (Figure 1). Ten-year yields have risen roughly 25bp since the last FOMC meeting, of which about 12bp came from higher inflation expectations (Figure 2).

The Fed may need to deliver a rate hike in September to counter doubts that its commitment to price stability is verbal only. **Since July, the Fed and Treasury have been in a feedback loop.** While the market's hike probability was under 50% heading into the July meeting, it had increased in the days leading up the vote. Markets appeared to be hoping for a rate hike although not predicting one. As a result, they may have been disappointed when the Fed left rates unchanged in July. This caused term rates to rise and the Treasury responded by unexpectedly increasing the size of its buybacks. However, this week's buyback announcement was smaller than anticipated and yields moved even higher. They moved even higher (above 4.95%) following the operation which was smaller than the \$6bn maximum.

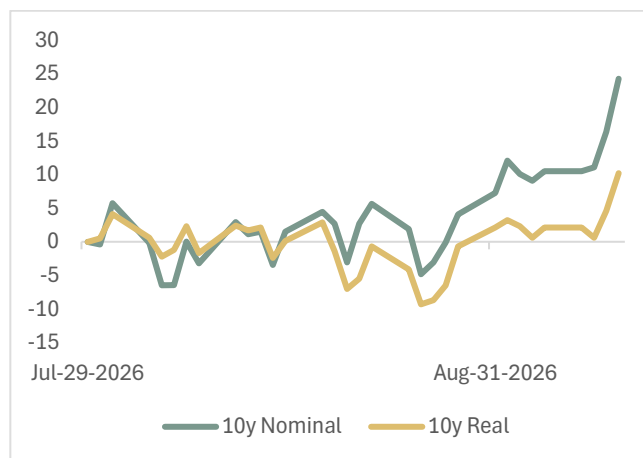
Markets are now looking to the Fed to break the cycle. By hiking rates next week, the Fed may do more to lower term interest rates than the Treasury had hoped its buybacks might achieve.

Figure 1: S&P 500 profits (%y/y)



Source: Bloomberg, SMBC Nikko

Figure 2: 10y yields (cumulative change since FOMC, bp)



Source: Fed, SMBC Nikko

Corporate issuance

Is some of the backup in 10y yields related to corporate issuance? As hyperscalers ramp up their AI infrastructure investment could their heavier borrowing be competing for the same pool of capital as Treasury buyers? If the Treasury is being crowded out then the Fed's September decision and Treasury's buybacks may only partially reverse the backup in 10y yields.

Evidence of corporate crowding out is weak. Corporate IG issuance this year is expected to exceed 2020's record of \$1.8trn. But most of the issuance is replacement debt – net new corporate supply is expected to increase \$750bn this year. Through the end of August, the Treasury has already raised \$900bn in net coupon supply. **Coefficients on the changes in net corporate supply in term premium equations are small and insignificant.** Mechanically, this may be because changes in corporate supply are typically small compared to Treasury's net issuance and the explanatory power of the debt/GDP ratio is strong. Drilling down, Christensen and Rudebusch use event analysis to examine AI-announcement

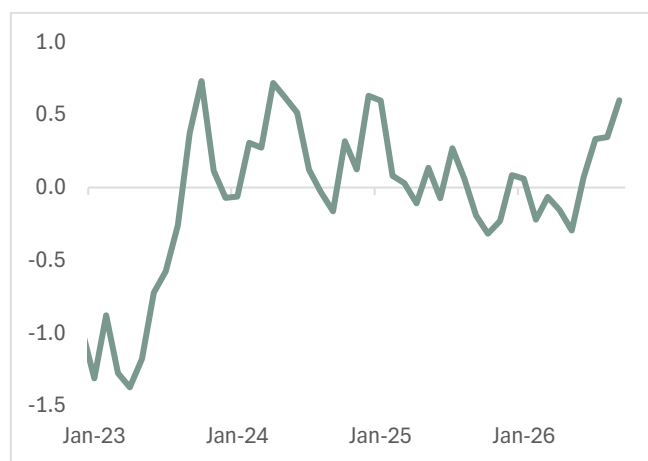
effects on r^* .² They find [little effect](#) although this may partly be because strong AI-productivity effects have yet to emerge.

We are less convinced that investors view high grade corporates and Treasuries as close substitutes. If heavier corporate issuance was pushing Treasury yields higher, we might expect corporate spreads to widen as well. **Overall, our sense is that any effect from heavier corporate issuance is small; the bulk of the back up in Treasury rates instead reflects inflation expectations and a series of policy disappointments.**

Is 5% attractive?

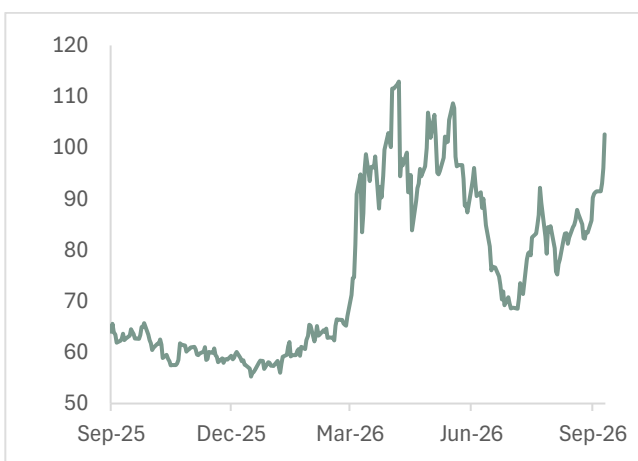
We think the 10y yield at 4.95% is cheap to our fair value model. This is as cheap as it got in January 2025 and only about 10bp richer than in October 2023 and April 2024. Our model is based on the real neutral rate and inflation expectations (Figure 3). It suggests that fair value is 4.30% with a residual of 65bp compared to 10bp over the last year. While market momentum could push yields above 5%, we think the risk-reward increasingly favors adding duration. The factors pushing the residual higher include a combination of rising inflation expectations, Fed credibility and higher global rates. Investors who are underweight duration should find current levels attractive and a good area at which to start covering their shorts.

Figure 3: Residual of 10y in fair value model



Source: Bloomberg, SMBC Nikko

Figure 4: WTI (\$/bbl)



Source: Bloomberg, SMBC Nikko

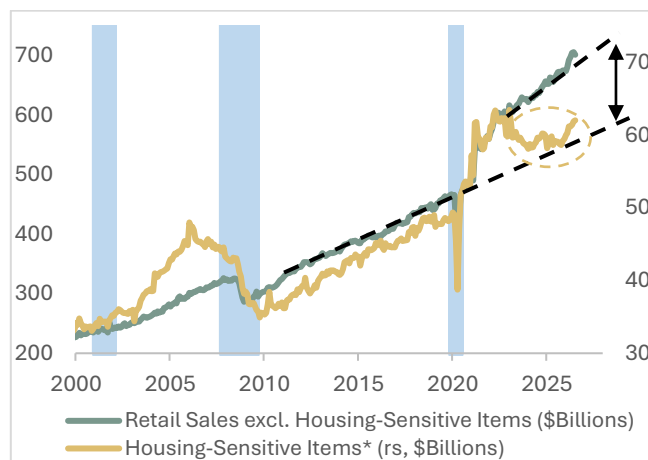
The rise in WTI so far this month, is an immediate concern for expected inflation and yields (Figure 4). However, if the Fed reasserts its credibility, much of the inflationary impulse from higher oil should be borne by the front end. Overall, attractive valuations, expectations for the Fed to re-establish credibility, and supportive technical factors, suggest that the medium-term risk-reward favors a long in the 10y.

Week ahead

² See "Can Fiscal, AI, or Monetary News Explain the Rise in r^* ?", J. Christensen and G. Rudebusch, Brookings Institute Working Paper, August 2026.

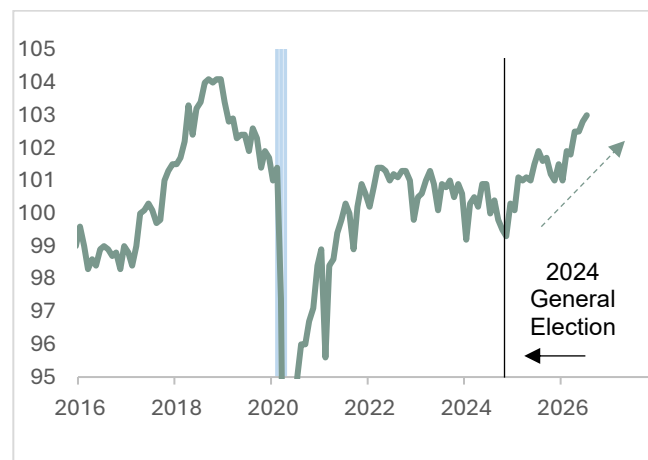
- Retail Sales (Aug, Wed):** We look for retail sales to rebound in August with the headline up 0.7%*m/m* and excluding autos up 0.6%*m/m*. The rebound follows a cooling in spending following Amazon's prime day. Total vehicle sales increased 2.4% in August and higher gasoline prices pushed service station sales up. In real terms, retail sales are up just 0.3% since April 2022 as spending on housing-related goods has been weak (Figure 5).
- Industrial Production (Aug, Friday):** Industrial production is expected to increase 0.3%*m/m*. Since November 2024, industrial production has increased 3.7% led by business equipment (Figure 6).

Figure 5: Retail Sales excl. Housing-Sensitive Items vs. Housing Sensitive Items



Source: Census, Haver, SMBC Nikko

Figure 6: Industrial Production Index (2017=100)



Source: Federal Reserve, Haver, SMBC Nikko

Table 3: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Sep 16	Retail Sales (8:30 AM)	0.7%	0.8%	-0.6%	0.2% - +1.1%	Rebound expected following July's post Amazon Prime day hangover. Vehicle sales increased by 2.4% in Aug.
Sep 16	Retail Sales ex autos (8:30 AM)	0.6%	0.5%	0.3%	0.2% - +0.8%	Chicago Fed CARTS data point to 0.5% August increase. Gasoline prices increased by 3.2%.
Sep 16	Fed Funds Upper Bound (2 PM)	4.0%	3.75%	3.75%	3.75% - +4.0%	We're expecting a September rate hike.
Sep 17	Housing Starts MoM (8:30 AM)	2.7%	6.9%	-12.4%	6.1% - +8.2%	Housing starts slowly trending lower since 2023.
Sep 18	Industrial Production MoM (9:15 AM)	0.3%	0.3%	0.2%	0.0% - +0.4%	Manufacturing payrolls increased by 0.1% in August, while steel production increased by 6.3%.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

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